THE SENATE COMMITTEE ON
VETERAN AFFAIRS & MILITARY INSTALLATIONS

JERRY PATTERSON
Chairman

Mark D. Loeffler
Director

Sam Houston Rm. 460
P.O. Box 12068
Austin, Texas 78711
(512) 463-2211
Fax: (512) 463-7683
TDD: 1-800-735-2989
http://www.patterson.senate.state.tx.us

GREGORY LUNA
Vice Chairman
J.E. "Buster" Brown
Troy Fraser
Eliot Shapleigh

February 20, 1998

RQ-1092

The Honorable Dan Morales
Attorney General
State of Texas
P. O. Box 12548
Austin, Texas 78711-2548

RE: REQUEST FOR OPINION

Dear Attorney General Morales:

As chairman of the Senate Veteran Affairs and Military Installations Committee, I am asking for your opinion with respect to various issues that have been raised by House Joint Resolution 31, that was enacted into law as an amendment to the Texas Constitution, Section 50, Article XVI, popularly referred to as the "Home Equity Amendment". The vagaries of this amendment have fostered an uncertain environment in the lending community as to the permissibility of certain actions and fees in connection with these loans. Given that these loans are nonrecourse, and failure to abide by certain requirements in the amendment may invalidate the liens securing such loans, noncompliance with the requirements of the amendment may result in outright "gifts" to borrowers, leaving lenders no recourse whatsoever in connection with collecting on these loans. The issues that are of most concern to many in the lending community consist of the following:

1. The types of fees and collateral requirements that may be charged or imposed in connection with a home equity loan without regard to the three percent (3%) limitation;

2. Whether larger acreage property that exceeds the maximum acreage permissible for urban or rural homesteads, as applicable, limits a lender's ability to assert a lien against the entirety of the residential property;

3. Whether language within the amendment would preclude a closed-end "advancing" loan;

4. Whether the amendment requires that notice and an opportunity to cure be given to a lender prior to invalidating a lien based upon the lender's noncompliance with the requirements of Section 50(a)(6).

Each of these issues are discussed in further detail along with the specific question for which I am requesting your opinion:

(1) Fees Not Subject to the 3% Limitation.

Section 50(a)(6)(e) prohibits lenders from requiring the owner or the owner's spouse to pay "in addition to any interest, fees to any person that are necessary to originate, evaluate, maintain, record, insure, or service the extension of credit that exceed, in the aggregate, 3% of the original principal amount of the extension of credit."

As you are aware, the Office of Consumer Credit Commissioner, Department of Banking, Savings and Loan Department, and Credit Union Department on January 6, 1998, jointly issued a "Regulatory Commentary on Equity Lending Procedures" (the "Commentary"). These agencies lack interpretive authority over constitutional provisions and, for that reason, many of the conclusions described in the Commentary may be less persuasive than opinions issued by the Attorney General, pursuant to its constitutional and statutory obligations. For this reason, notwithstanding the fact that the Commentary concludes that the 3% limitation does not apply to premiums paid by the borrower in connection with property casualty insurance that the lender requires the borrower to maintain on the collateral, I am requesting your opinion on this issue. In addition, the rationale for some of the conclusions described in the Commentary appear logically flawed. For example, the rationale in support of the Commentary's view that the 3% limitation does not apply to property casualty insurance premiums is based upon its analysis that the homeowner's failure to maintain insurance is a "subsequent event" from the closing of the home equity loan and therefore should not be covered. Since fees charged in connection with servicing activities are also resultant from events subsequent to closing, and fees to service the extension of credit are expressly covered, it appears that reliance on "subsequent events" in analyzing the permissibility of a fee is misplaced. It appears that a better analysis would consider whether the insurance premiums are, indeed, fees to "originate, evaluate, maintain, record, insure, or service the extension of credit". Property casualty insurance premiums are premiums that are required to insure the collateral, not the extension of credit, and are payable in connection with an independent benefit offered to the borrower, that being casualty insurance. Obviously, mortgage insurance required by the lender would be insurance of the extension of credit and would be covered by the 3%. Your opinion is specifically requested as to whether property casualty insurance premiums paid by a borrower for property casualty insurance on the collateral securing a home equity loan is subject to the 3% limitation.

(2) Does 50(a)(6)(H) Limit the Acreage of the Homestead that May Serve as Collateral for a Home Equity Loan?

Section 50(a)(6)(H) prohibits the home equity lender from obtaining any "additional real or personal property other than the homestead" as collateral for the loan. Article XVI, Section 51 of the Texas Constitution limits an urban homestead to not more than one (1) acre of land, together with any improvements on the land and a rural homestead to 200 acres of land. Many residential home owners have homes that are located on parcels of land that exceed one acre and are located in urban areas. Lenders and the secondary mortgage market, notably FNMA, have taken the position that this section of the home equity amendment prohibits lenders from asserting a security interest in the

entirety of a residential parcel if that parcel exceeds the applicable acreage allotment under Section 51, presumably based upon the assumption that this excess acreage would deem to be "additional real property" prohibited under 50(a)(6)(H). In order to extend home equity loans to owners of "urban" residential property in excess of an acre, if the excess acreage is deemed to be "additional real property", lenders would be forced to require a partition of the property to include only that portion thereof that is within the applicable acreage allotment. In many areas, deed restrictions, zoning ordinances, or other land use restrictions would prohibit lots for residential purposes of less than a certain size that may exceed the one acreage "allotment" for an urban homestead. Additionally, even if applicable zoning or land use ordinances or deed restrictions did not prohibit such a subdivision, actually subdividing the property would require additional legal and survey expenses that would make the loan cost prohibitive for either the lender or the consumer, depending on who pays for these expenses.

The specific questions, then, with respect to this issue is: "If the parcel of property upon which the homestead is located exceeds the acreage allotment for the urban homestead or rural homestead, as applicable, may the lender take a security interest in the entire parcel without violating Section 50(a)(6)(H)?"

(3) Does the Home Equity Amendment Permit an Advancing Loan?

Section 50(a)(6)(F) provides that a home equity loan may not be a form of open end account that may be debited from time to time or under which credit may be extended from time to time. Additionally, Section 50(a)(6)(L) requires that the home equity loans be scheduled to be repaid in substantially equal successive monthly installments beginning no later than two months from the date the extension is made. The Commentary indicates that "closed end" advancing loans are permissible under the home equity amendment, notwithstanding the provisions of 50(a)(6)(L) that require the loan to be repaid in substantially equal successive monthly installments beginning no later than two months from the date the extension of credit is made. Does the Attorney General believe that the home equity amendment permits loans in a finite amount to be advanced from time to time, provided that the loan is not a revolving loan which may be borrowed, repaid and reborrowed?

(4) Does the Home Equity Amendment Permit Notice and Cure with Respect to Lien Validity?

Section 50(a)(6)(x) provides:

> "The lender or any holder of the note for the extension of credit shall forfeit all principal and interest of the extension of credit if the lender or holder fails to comply with the lender's or holder's obligation under the extension of credit within a reasonable time after the lender or holder is notified by the borrower of the lender's failure to comply".

It is unclear whether this section was intended to permit a notice and cure opportunity with respect to the lender's failure to observe certain conditions or its imposition of requirements that exceed the permissible scope of actions set forth in Section 50(a)(6) as conditions precedent to the creation of

a valid home equity lien. It could certainly be argued that this was the intent, inasmuch as a home equity loan, pursuant to Section 50(a)(6)(C), must be a nonrecourse loan. Accordingly, if the lien securing a home equity note is deemed to be invalid, because the note is nonrecourse, such invalidity would automatically result in a forfeiture of principal and interest of the extension of credit. Many lenders believe that this section, then, is intended as providing the lender with an opportunity to cure those aspects of the home equity loan that do not comply with Section 50(a)(6) in its entirety. Others have taken the position that this section was merely intended as an automatic forfeiture of all principal and interest, including payments already made by the borrower, if the lender failed to comply with contractual provisions set forth in the loan documents separate and apart from those conditions that must be observed in connection with establishing a valid home equity lien.

The specific question, then, in connection with this issue is: Does Section 50(a)(6)(x) require that a lender be given reasonable notice and opportunity to cure deficiencies that would otherwise defeat the validity of a lien asserted in connection with a home equity loan?

Given the admitted ambiguities in the Home Equity Amendment, many of the conditions to the creation of a valid home equity lien are unclear and, if literally interpreted, may either result in unsafe and unsound practices by the lending community or restricted availability of home equity loans. Accordingly, your prompt response to these questions is appreciated.

Yours Respectfully,

Jerry Patterson
State Senator
Chairman, Veteran Affairs & Military Installations Committee